

Message Text

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C O N F I D E N T I A L SECTION 1 OF 2 MADRID 5643

E.O. 11652: GDS

TAGS: PINT, ECON, SP

SUBJECT: SPANISH ECONOMIC POLICY AND OUTLOOK AND EMBASSY VIEWS

REF: MADRID 5505 (NOTAL), MADRID 5521

1. SUMMARY. THE NEW GOVERNMENT'S DECLARATION OF ECONOMIC PRINCIPLES AND OBJECTIVES IS A GENERAL STATEMENT FAVORING PRIVATE ENTERPRISE AND PROPOSING NO RADICAL OR QUICK SOLUTIONS TO ECONOMIC PROBLEMS. EMPHASIS IS ON NEED TO REDUCE INFLATION ALONG WITH SELECTIVE REACTIVATION IN SECTORS MOST SUSCEPTIBLE TO CREATING EMPLOYMENT. VARIOUS POINTS CONCENTRATE ON NEED FOR UNSPECIFIED FISCAL AND CREDIT MEASURES TO FOSTER PRIVATE INVESTMENT AND STIMULATE EXPORTS. DESIRABILITY OF FREE, WESTERN-TYPE, LABOR ACTIVITY RECOGNIZED. EFFICACY OF PROGRAM WILL DEPEND ON POLICIES ADOPTED TO IMPLEMENT THESE GENERAL OBJECTIVES. ECONOMIC
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PROBLEMS, PARTICULARLY IN RELATION TO INFLATION AND TO

THE VOLATILE LABOR SITUATION, CAN BE A SERIOUS THREAT TO MEASURED POLITICAL REFORM. DEALING WITH THEM WILL REQUIRE DEGREE OF WILL AND STRENGTH WHICH IS PROBLEMATIC FOR THIS GOVERNMENT. MUCH WILL DEPEND ON DEGREE TO WHICH BUSINESS CONFIDENCE IS BOLSTERED. THIS, IN TURN, WILL DEPEND AS MUCH ON POLITICAL AND PUBLIC ORDER DEVELOPMENTS AS ON ECONOMIC AND FINANCIAL POLICIES. WE SHOULD ENCOURAGE RESPONSIBLE BUT MODERATE APPROACH BASED ON JUDICIOUS BALANCE BETWEEN REQUIRED ECONOMIC FINANCIAL MEASURES AND POLITICAL REALITIES. SUCH APPROACH WOULD PROVIDE BEST PROSPECTS FOR SMOOTH POLITICAL TRANSITION AND FOR PROTECTING U.S. TRADE AND INVESTMENT INTERESTS. END SUMMARY.

2. ECONOMIC PORTION OF GOVERNMENT PROGRAM DECLARATION ISSUED JULY 17 IS GENERAL STATEMENT OF GOALS AND PRINCIPLES RATHER THAN ENUNCIATION OF SPECIFIC POLICY MEASURES. THE PROGRAM IS CONSERVATIVE AND ESCHEWS ANY RADICAL OR QUICK-FIX SOLUTIONS TO SPAIN'S ECONOMIC PROBLEMS. EMPHASIS IS ON RESTORING CONFIDENCE OF THE PRIVATE BUSINESS SECTOR, PARTLY THROUGH FISCAL INCENTIVES, ALONG WITH RESTORING INTERNAL AND EXTERNAL EQUILIBRIUM BY REDUCING INFLATION AND BUDGET DEFICITS. AT THE SAME TIME, IT PROMISES GOVERNMENT EXPENDITURES FOR SELECTIVE REACTIVATION IN SECTORS HAVING GREATEST CAPACITY FOR INCREASING EMPLOYMENT AND IN REGIONS WHERE ECONOMY MOST DEPRESSED, INCLUDING AGRICULTURE IN GENERAL. IT ALSO FLATLY RECOGNIZES THE DESIRABILITY OF ORDERING LABOR RELATIONS ALONG WESTERN LINES WITH EXPRESS RECOGNITION OF UNION FREEDOMS IN CONFORMITY WITH ILO PRINCIPLES. ON THE EXTERNAL SIDE, IT CALLS FOR CREDITS AND GENERAL GOVERNMENT SUPPORT TO STIMULATE EXPORTS AND UNSTATED MEASURES TO ENCOURAGE IMPORT SUBSTITUTION WITHOUT CLOSING SPANISH ECONOMY TO COMPETITION. THE OBJECTIVES ARE SOUND AND AS GOALS SHOULD APPEAL TO A BROAD SPECTRUM OF THE SPANISH PUBLIC, SINCE THEY COMBINE SUPPORT FOR POWERFUL BUSINESS INTEREST WITH RECOGNITION OF WORKERS RIGHT TO ORGANIZE FULLY, SELECTIVE REACTIVATION MEASURES, AND PROMISES TO DEAL WITH INFLATION WHICH AFFECTS ALL CONSUMERS.

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3. THE TEST WILL BE IN DESIGNING SPECIFIC POLICIES TO IMPLEMENT THIS VERY GENERAL, AND ESSENTIALLY POLITICAL, STATEMENT OF PRINCIPLES AND OBJECTIVES. IN THIS SENSE, THE DECLARATION IS INTERESTING AS MUCH FOR WHAT IT DOES NOT SAY AS FOR WHAT IT DOES. IT DOES NOT MENTION TARGETS FOR GROWTH, EMPLOYMENT, OR PRICE STABILIZATION. IN FACT, IT CONTAINS NO STATISTICS BY WHICH MAGNITUDE OF PROBLEMS

OR SUCCESS IN RECTIFYING THEM CAN LATER BE JUDGED.
IT DOES NOT SIGNAL A SWEEPING STABILIZATION PROGRAM.
IT PROPOSES NO DRACONIAN MEASURES TO DEAL WITH PRESSING
ECONOMIC PROBLEMS, NOR DOES IT MENTION OVERALL TAX REFORM
MEASURES WHICH HAVE NEVER SEEN THE LIGHT OF DAY WHEN
PROPOSED BY PREVIOUS SPANISH GOVERNMENT MINISTERS.
IN SHORT, THIS IS A PHILOSOPHICAL STATEMENT OF A CABINET
WHICH HAS DEFINED ITSELF AS A CARETAKER GOVERNMENT AND
WHICH IS UNLIKELY TO INSTITUTE MAJOR SPECIFIC MEASURES
THAT COULD BE POLITICALLY DIFFICULT.

4. THE PROBLEM IS THAT SPAIN HAS PRESSING ECONOMIC DIS-
LOCATIONS WHICH ARE DIFFICULT TO ATTACK WITHOUT SOME
MEASURE OF AUSTERITY AND WHICH WILL HAVE AN INCREASING
IMPACT ON THE POLITICAL PROCESS. AS THE NEW SPANISH
GOVERNMENT UNDER THE LEADERSHIP OF ADOLFO SUAREZ PROCEEDS
ALONG THE DIFFICULT PATH OF POLITICAL REFORM WITH TARGETS
FOR A REFERENDUM IN THE FALL AND PARLIAMENTARY ELECTIONS
BY NEXT JUNE, ECONOMIC CONDITIONS MAY WELL BECOME A
FORMIDABLE HURDLE BLOCKING THE WAY TO A SMOOTH TRANSITION
TO SOME FORM OF DEMOCRACY.

5. SPAIN'S DIFFICULT ECONOMIC SITUATION, INDUCED BY THEM MORE
THAN THREE-FOLD INCREASE IN ITS FUEL BILL, POLITICAL
UNCERTAINTIES FLOWING FROM FRANCO'S ILLNESS AND FINAL
PASSING, AND TEMPORIZING ECONOMIC POLICIES, HAS IMPROVED
PERCEPTIBLY SINCE JUAN CARLOS ASSUMED THE THRONE. WHILE
THERE ARE SOME UNCERTAIN SIGNS (NOTABLY INCREASED INDUSTRIAL
OUTPUT AND ELECTRIC ENERGY CONSUMPTION) THAT A RECOVERY MAY
BE UNDERWAY, INFLATION AND UNEMPLOYMENT HAVE BECOME WORSE
AND PROBABLY CONTRIBUTED TO THE DECISION TO DUMP ARIAS. THE
TRADE DEFICIT DURING FIRST FIVE MONTHS OF 1976 WAS SOMEWHAT
LESS THAN SAME PERIOD OF 1975, BUT WILL PROBABLY WORSEN
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DURING REMAINDER OF YEAR AS IMPORTS OF HIGH PRICED CORN
AND OTHER FEED GRAINS INCREASE. IN ADDITION, ANOTHER
OIL PRICE INCREASE CANNOT BE RULED OUT. ADD IN LOWER
RECEIPTS FROM TOURISM THIS YEAR (DOWN 9 PERCENT THUS
FAR COMPARED WITH 1975) AND THE PROSPECTS ARE FOR A LARGER
CURRENT ACCOUNT BALANCE OF PAYMENTS DEFICIT THAN ORIGIN-
ALLY FORECAST, AT LEAST AS HIGH AS \$3.4 BILLION AND
POSSIBLY MORE. THE \$1 BILLION LOAN FROM PRIVATE BANKS
WHICH FORMER FINANCE MINISTER VILLAR MIR WAS ABLE TO
ARRANGE ALONG WITH SMALLER IMF CREDITS WILL BE HELPFUL,
BUT RESERVES MAY HAVE TO BE DRAWN DOWN BY AS MUCH AS
\$2 BILLION TO COVER THIS YEAR'S DEFICIT AND FOREIGN
DEBT AMORTIZATION.

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C O N F I D E N T I A L SECTION 2 OF 2 MADRID 5643

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6. THE ONLY INDICATION THUS FAR OF ECONOMIC POLICIES
GOS MAY FOLLOW IN ADDITION TO NEW GOVERNMENT'S DECLARATION
OF ECONOMIC OBJECTIVES HAS BEEN ANNUAL REPORT OF BANK
OF SPAIN IN WHICH GOVERNOR (SINCE 1970) CORONEL DE PALMA
EMPHASIZED NEED TO AVOID AN EXPANSIONARY MONETARY POLICY
IF INFLATION IS TO BE BROUGHT UNDER CONTROL. IN SHORT RUN,
HE ASSERTED, GOVERNMENT SHOULD STRIVE TO LIMIT GROWTH
IN MONEY SUPPLY TO AN ANNUAL RATE OF 16 PERCENT WHILE
RUNNING MODERATE BUDGETARY DEFICITS TO STIMULATE EMPLOY-
MENT IN MOST DEPRESSED SECTORS AND REGIONS. HE WARNED
THAT IN LONGER RUN, DEFICIT FINANCING HAS LIMITS AS BANK
FINANCES PUBLIC DEFICITS AT EXPENSE OF PRIVATE CAPITAL
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MARKET ON WHICH NEW INVESTMENT DEPENDS. ALL OF THIS IS NO DIFFERENT FROM ECONOMIC POLICY OFTEN ENUNCIATED BY FORMER FINANCE MINISTER VILLAR MIR WHO WAS SUBJECTED TO CONSTANT CRITICISM FOR FAILURE TO COME TO GRIPS WITH PRESSING ECONOMIC ISSUES.

7. SPAIN'S ECONOMIC SITUATION AND OUTLOOK IS MORE SERIOUS THAN GOVERNMENT SPOKESMEN HAVE YET BEEN WILLING TO ADMIT PUBLICLY. MOST PRESSING PROBLEMS ARE INFLATION, LARGE BALANCE OF PAYMENTS DEFICIT, FALTERING INVESTMENT, AND UNEMPLOYMENT. GOVERNMENT HAS CORRECTLY IDENTIFIED INFLATION AS THE PRIORITY ISSUE IN THE SHORT RUN SINCE INVESTOR CONFIDENCE, COMPETITIVENESS OF EXPORTS, AND MODERATION OF WORKER WAGE DEMANDS ALL DEPEND IN PART ON BRINGING SPIRALING PRICES UNDER CONTROL. THE PROBLEM IS THAT NO EFFECTIVE MEASURES HAVE BEEN TAKEN TO CURB INFLATION. THUS FAR THIS YEAR, THE MONEY SUPPLY HAS INCREASED AT AN ANNUAL RATE OF 21 PERCENT, NOMINAL PRICE CONTROLS HAVE NOT BEEN ENFORCED, WAGE DEMANDS IN EXCESS OF GUIDELINES HAVE BEEN MET, AND EMPLOYERS HAVE PASSED INCREASES ALONG TO CONSUMERS IN ORDER TO MAINTAIN OR IMPROVE PROFIT MARGINS. LONGER RANGE PLANS FOR TAX REFORM AND IMPROVEMENT OF PRODUCTIVITY, PARTICULARLY IN AGRICULTURE, HAVE BEEN BURIED IN CORTES COMMITTEES.

8. TO COMBAT INFLATION EFFECTIVELY, THE GOS WOULD HAVE TO RESTRICT THE INCREASE IN MONEY SUPPLY BY ACTIONS INCLUDING INCREASED TAXATION AND PROBABLY REDUCED PUBLIC EXPENDITURES, RESTRICTIONS ON CREDIT, AND MORE EFFECTIVELY ENFORCED WAGE SETTLEMENT GUIDELINES.

JUDGING FROM FUTURES' QUOTATIONS, THE PESETA IS OVERVALUED AND SHOULD BE ALLOWED TO FLOAT DOWNWARD. THE PROBLEMS FOR THE PRESENT GOVERNMENT IN DOING ALL THESE THINGS ARE LARGE. FIRST, IT HAS DEFINED ITSELF AS A CARETAKER GOVERNMENT UNTIL THE WILL OF THE PEOPLE IS EXPRESSED IN ELECTIONS; SECOND, THE NEEDED FISCAL ACTIONS ARE COMPLEX AND POLITICALLY CONTROVERSIAL AND WOULD, AT THE BEST, TAKE TIME; THIRD, SOME OF THE GOVERNMENT LEADERSHIP, INCLUDING PROBABLY THE KING, ARE LIKELY TO BE MORE ATTRACTED BY SHORT-TERM REACTIVATION

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MEASURES THAN BY STABILIZATION ACTIONS; AND FOURTH, WAGE CONTRACTS COME UP FOR RENEWAL IN THE FALL WHEN THE COUNTRY WILL BE IN THE MIDST OF A REFERENDUM. WORKERS

WILL BE PRESSING FOR LARGE WAGE INCREASES WHICH THEY LOOK UPON AS A MEANS TO CATCH UP WITH PAST INFLATION. WITH FREER LABOR ACTIVITY IN THE OFFING, THE GOVERNMENT WILL HAVE TO EXERCISE ALL ITS POLITICAL SKILLS IN ATTEMPTING TO STRIKE SOME BARGAINS FOR A SOCIAL PACT WHERE LABOR WILL AGREE TO ACCEPT GOVERNMENT GUIDELINES FOR WAGE HIKES NO HIGHER THAN COST OF LIVING INCREASE.

9. LACK OF BUSINESS CONFIDENCE HAS BEEN A MAJOR PROBLEM OVER THE PAST YEAR OR MORE. IT IS EVIDENCED BY THE LOW LEVEL OF INVESTMENT AND BY CAPITAL FLIGHT DESPITE SUPPOSEDLY STRICT CONTROLS. (WE HAVE BEEN TOLD THAT BANK OF SPAIN OFFICIALS VISIT ZURICH WEEKLY TO PURCHASE EXCESS PESETAS AND THAT DURING THE FIRST 4 MONTHS OF THIS YEAR SUCH PURCHASES HAVE BEEN TEN TIMES GREATER THAN DURING ALL OF 1975. GOS OFFICIALS ALSO BELIEVE THAT HIGH IMPORTS DURING TIME OF RECESSION ARE IN PART RESULT OF PADDED INVOICES.) AN IMPORTANT ASPECT OF THE DECLARATION OF OBJECTIVES AND OF THE ECONOMIC POLICIES THAT FLOW FROM THEM WILL BE EXTENT TO WHICH THEY ARE HELPFUL IN RESTORING BUSINESS CONFIDENCE. THE MAIN FACTORS INFLUENCING CONFIDENCE, HOWEVER, ARE PROBABLY POLITICAL AND PUBLIC ORDER UNCERTAINTY.

10. THE MODERATE, NON-UTOPIAN CHARACTER OF THE SUAREZ GOVERNMENT'S FIRST GENERAL OUTLINE OF GOS ECONOMIC ORIENTATION, WHILE NOT SHEDDING MUCH LIGHT ON SPECIFIC ECONOMIC POLICIES, SUGGESTS WE WILL BE FACED WITH NO RADICAL DEPARTURES FROM THE PRESENT MACRO-ECONOMIC POLICIES OR FROM PRESENT ATTITUDES TOWARD FOREIGN INVESTMENT OR COMMERCIAL POLICY. WE SHOULD, WHENEVER POSSIBLE, ENCOURAGE SPAIN TO PURSUE AS RESPONSIBLE FINANCIAL POLICIES AS ARE POLITICALLY FEASIBLE. WHILE IT IS RECOGNIZED THAT THIS GOVERNMENT DOESN'T HAVE THE POLITICAL STRENGTH TO IMPOSE SWEEPING STABILIZATION MEASURES, THE FINANCIAL PROBLEM WILL BE THE WORSE, AND THE SOCIAL AND POLITICAL EFFECTS THE MORE INSIDIOUS, THE LONGER IT WAITS. THERE IS NO GUARANTEE THAT THE NEXT GOVERNMENT WILL REALLY BE IN A BETTER POSITION TO ACT. THEREFORE THE PRESENT GOVERNMENT SHOULD DO ALL IT POLI-
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TICALLY CAN IN TERMS OF RESPONSIBLE POLICIES TO SLOW INFLATION AND CORRECT SPAIN'S EXTERNAL BALANCE. A PROGRAM THAT COMBINES SOME MEASURE OF TAX ACTION, OVERALL GOVERNMENT EXPENDITURE RESTRAINT, CREDIT LIMITATION AND A GRADUAL EXCHANGE RATE MOVEMENT WITH SELECTIVE REACTIVATION MEASURES AND SOME WAGE RESTRAINT SHOULD NOT BE OUT OF THE QUESTION. SUCH A PROGRAM NOT ONLY WOULD HAVE LONGER-TERM BENEFICIAL INTERNAL ECONOMIC AND POLITICAL EFFECTS, BUT ALSO WOULD ALSO HAVE THE ADDED BENEFIT FOR US THAT IT WOULD LIMIT PRESSURES TO DEAL WITH THE EXTERNAL BALANCE PROBLEM BY IMPORT RESTRICTIONS.

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